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REMARKS AT THE 2005 UNIVERSITY OF SOUTHERN CALIFORNIA TAX INSTITUTE

THE ECONOMIC SUBSTANCE DOCTRINE IN THE CURRENT TAX SHELTER ENVIRONMENT

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Introduction

As I'm sure all of you are aware, one of the most serious problems that the IRS has had to face over the past 10 years is the proliferation of abusive tax shelters. While the IRS and tax practitioners may not always agree on whether a particular transaction constitutes an abusive tax shelter, there is a consensus, I believe, at least among responsible tax practitioners, that the IRS must strive to identify and challenge those tax shelter transactions that are used by taxpayers to inappropriately avoid paying taxes.

By now, you should have received your Form 1040 package for 2004 in the mail. When you look at it, you will see that the package includes a letter from Commissioner Everson, in which he sets forth our working equation at the IRS -- "Service plus Enforcement equals Compliance."

In the category of "Service" -- or, in the Commissioner's words, "helping people understand their federal tax obligations and facilitating their participation in the tax system" -- I would highlight from the Office of Chief Counsel's perspective, its commitment to issuing not only a significant amount of published guidance but also making sure that the regulations and rulings we issue provide rules that are clear and

precise. For example, in the context of tax shelters, we have published rules regarding the disclosure of reportable transactions which, we believe, were successfully designed to balance the Service's need to identify questionable transactions with the tax policy goal of limiting the impact of the rules on routine business transactions. In addition, over the past several years, we have identified approximately 30 transactions as so-called "listed transactions" – these are transactions that the IRS and Treasury consider abusive and which must be disclosed to the IRS.

With respect to the "Enforcement" side of the equation, the Commissioner points out in his letter that "[e]nforcing the law is equally essential to our system of individual self assessment." As part of our enforcement effort, the IRS has undertaken several settlement initiatives for large groups of tax shelter transactions having similar fact patterns. As in all controversies, our goal is to resolve tax shelter cases as fairly and efficiently as possible. Recognizing that tax professionals play a crucial role in advising taxpayers on their tax obligations, the IRS has also recently re-energized the Office of Professional Responsibility which is dedicated to setting, communicating, and ensuring the standards of competence and conduct for those who practice before the IRS. Additionally, IRS agents in the Large and Mid-size Business Division are conducting over 150 promoter audits in a program designed to ensure that promoters comply with their registration and list maintenance obligations under the law. When you add the work done by agents in the Small Business/Self-Employed Division, the total promoter audits number over one thousand. Just as important, these audits also help us to identify as many questionable tax shelter transactions as possible as well as to examine the tax returns of the individuals and entities who participated in them.

All of these activities, of course, would be a waste of time for everyone involved if the IRS did not have effective arguments for challenging the abusive tax shelter transactions that it discovers. Thus, I believe that in every tax controversy, the IRS must be able to explain and justify to itself why it has concluded that the transaction a particular taxpayer has undertaken does not produce the tax benefits that have been claimed. That's just a good best practice.

Now, in some cases, the tax shelter issue presented may be specifically addressed by the Internal Revenue Code with the result that the benefit claimed should clearly be disallowed. In other cases, the IRS can refer to regulations which clearly prohibit the results claimed by the taxpayer.

However, as we all know, situations do exist where the Code and the regulations do not provide a clear answer on the proper tax treatment of a particular transaction, or may even be interpreted by some purveyors of abusive transactions and their advisors to permit the tax treatment claimed by the taxpayer when common sense might tell you otherwise. Virtually in every case, the IRS can make what are referred to as "technical arguments" to challenge such transactions. However, in some cases, it may also be appropriate for the IRS to consider whether the transaction should be challenged under one or more judicial doctrines including the so-called "economic substance" doctrine.

You will note that I said "in some cases" it is appropriate for the IRS to consider whether the transaction should be challenged under a judicial doctrine. This implies, of course, that a challenge should not be undertaken in every single tax shelter case. Why do I suggest that we limit our use of judicial doctrines such as the economic substance doctrine? Why not use it in every case? Well, the economic substance doctrine is not

supposed to be a general anti-abuse rule to be trotted out by the IRS every time it confronts a tax shelter transaction it simply does not like. In fact, in the vast majority of cases, the IRS does not need to raise the argument; the technical arguments it has available to it are more than enough to carry the day. But still, there are some tax shelter cases, even though they are a distinct minority of all of the cases we have to deal with, where it may be entirely appropriate for the IRS to use such a judicial doctrine to challenge the transaction.

Threshold Question

Naturally, before a court can determine whether a transaction lacks economic substance, the court must first determine whether the transaction itself did in fact actually occur. Thus, a court will not inquire into whether a transaction's primary objective was for the production of income or to make a profit, until it determines that the transaction is bona fide and not a factual sham.[1] This is a threshold question -- whether the transaction is a so-called "sham in fact." In effect in these transactions -- these sham transactions -- the taxpayers claim deductions for transactions that have been created on paper but which never in fact took place.

There are not as many of these types of cases today as we saw back in the late 1970's and early 1980's, during the heyday of the individual tax shelter industry. Needless to say, when a transaction never actually occurred, it is easy for a court to disallow the purported tax benefits on the fundamental ground that the transaction is not a real transaction.[2]

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[1] See Mahoney v. Commissioner, 808 F.2d 1219, 1220 (6th Cir. 1987). There, the court noted that once a court determines a transaction is a factual sham, "such niceties as whether it was 'primarily' for profit, or whether the text is an objective or subjective one are simply not involved."

[2] See, e.g., Lynch v. Commissioner, 273 F.2d 867, 871 (2d Cir. 1959).

Economic Substance Doctrine

Now, what if a court determines that a tax shelter transaction actually has happened? Must the court allow the tax benefits arising from the transaction even though the transaction lacks the presence of economic effects other than tax benefits? Or said another way, what can a court do if the transaction meets the literal language of the Code or regulations but does not appear consistent with the intent of Congress when the relevant statutory provisions were enacted? The answer to these questions is rather simple: in order for the tax benefits arising from this type of transaction to be respected, the court must conclude, that in addition to satisfying the appropriate Code provision or regulation, the transaction must also satisfy relevant judicial doctrines, including the economic substance doctrine.

It is the economic substance doctrine that I want to talk about today. I will summarize the key features of the doctrine as these features have been articulated by the courts, and then describe the circumstances under which the IRS is prepared to assert the economic substance doctrine in a particular case. Hopefully, my talk will make clear the important role that the doctrine plays in the administration of our tax system.

Now, why do I say that the doctrine plays such an important role in our tax system? Well, perhaps, it has been best said, by Harvard Law School Professor Bernie Wolfman when he wrote a letter to the editor of Tax Analysts last summer. Here is what he said:

> The [economic substance] doctrine has assured us that neither the government nor practitioners will succeed in their roles if they are excessively literal and mechanical in their reading of the statute; if they fail to read it as part of a

> statutory scheme through which Congress seeks to accomplish a goal that has breadth and durability.[3]

He goes on to point out that "[w]e must ask, and ask in every case, whether the transaction as consummated fits the language and the purpose of the statutory provisions in question."

Before I go on, I should point out that in some cases, courts have labeled transactions that lack economic substance as "shams in substance". I view these phrases as different ways of describing the same thing. For consistency, in my remarks today, I will refer to the doctrine as the "economic substance doctrine".

Similarly, oftentimes people lump together the judicially created doctrines of economic substance, business purpose, step transaction, and sham transaction. These are all really just subcategories of the "substance-over-form" doctrine which provides that where the form of a taxpayer's transaction may satisfy the literal requirements of the relevant statutory or regulatory language, a court can still examine whether the substance of that transaction was consistent with its form, for the simple reason that a transaction lacking such substance should not be accorded the tax treatment prescribed for the form of the transaction. Thus, for example, in situations where there is no substance other than the creation of unintended tax benefits, the courts may apply the economic substance doctrine to deny the purported tax benefits.[4]

Courts have treated the economic substance doctrine as a principle of statutory interpretation -- a tool to construe the text of the Internal Revenue Code. According to

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[3] See 104 Tax Notes 445 (July 26, 2004).

[4] In all substance-over-form inquiries, a court will examine whether the substance of the transaction was consistent with the form, and give effect only to the substance. "Economic substance" is the substance-over-form inquiry most particularly adapted to transactions devoid of substance. In a system designed to measure and tax income, transactions that do not change the taxpayer's economic position should have no effect at all.

these courts, the test does not necessarily apply when Congress has spelled out in the statutory language the parameters of the tax consequences of a specific form of transaction. The theory behind this approach is that the economic substance doctrine is "an important judicial device for preventing the misuse of the tax code, but the doctrine cannot be used to preempt congressional intent."[5]

Two-Prong Test

Let's discuss some of the details.

What is the test for economic substance? Will the Supreme Court has said that in order to be respected, a transaction must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction.[6] This formulation has resulted in transactions being recognized as having economic substance if (1) the transaction is rationally related to a useful nontax business purpose that is plausible in light of the taxpayer's conduct and economic situation, and (2) the transaction results in a meaningful and appreciable enhancement in the net economic position of the taxpayer (other than to reduce its tax).[7]

So how do we determine whether a specific transaction has economic substance? One way is to analyze the transaction by using a two-prong test: (1) the subjective intent of the taxpayer entering into the transaction, and (2) the objective economic substance of the transaction.

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[5] Horn v. Commissioner, 968 F.2d 1229, 1236 (D.C. Cir. 1992). See also TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004); Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995).

[6] See Frank Lyon Co. v. U.S., 435 U.S. 561, 583-84 (1977).

[7] See Knetsch v. United States, 364 U.S. 361 (1960); Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir. 1985); Pasternak v. Commissioner, 990 F.2d 893 (6th Cir. 1993); ACM P'ship v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), aff'g in part and rev'g in part, T.C. Memo 1997-115, cert. denied 526 U.S. 1017 (1999).

On the other hand, some courts do not determine economic substance by this rigid two-prong test. Instead, when these courts consider the issue, they tend to view business purpose and economic substance as simply more precise factors to determine "whether the transaction had any practical economic effects other than the creation of income tax losses."[8]

One other point to note -- among the United States Courts of Appeals that apply the two-prong test, there is disagreement as to whether the test is disjunctive or conjunctive. For example, the Fourth Circuit applies the test disjunctively: a transaction will have economic substance if the taxpayer had either a nontax business purpose or the transaction had objective economic substance.[9] However, the Eleventh Circuit applies the test conjunctively: a transaction will have economic substance only if the taxpayer had both a nontax business purpose and the transaction had objective economic substance.[10]

It is quite possible that someday soon the Supreme Court will be faced with deciding which test to apply in determining the economic substance of a transaction in connection with one of the so-called listed transactions I referred to earlier. When that day comes it will be interesting to see what formulation of the test carries the day. Will it be a rigid disjunctive or conjunctive two-prong test or a practical economic consequence test? Only time will tell.

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[8] Sochin v. Commissioner, 843 F.2d 351, 354 (9th Cir. 1988). See also Rose v. Commissioner, 868 F.2d 851 (6th Cir. 1989).

[9] Rice's Toyota World, supra note 7, at 91-92.

[10] See United Parcel Service of America v. Commissioner, 254 F.3d 1014, 1018 (11th Cir. 2001) (citing Kirchman v. Commissioner, 862 F.2d 1486, 1492 (11th Cir. 1989)). Note that recent congressional bills have included proposals to codify the economic substance doctrine. See, e.g., S. 1637, 108th Cong. section 401 (Jumpstart Our Business Strength (JOBS) Act); S. 476, 108th Cong. section 701 (CARE Act of 2003). These bills would have required the taxpayer's transaction to satisfy both components of the doctrine in order to be respected for tax purposes.

Subjective Component

Let's turn to the subjective component of the doctrine. In order to satisfy the subjective component, the taxpayer must demonstrate that the taxpayer was motivated by the opportunity to profit from the transaction, or at least had a valid business reason for entering into the transaction other than tax savings. In essence, the taxpayer must demonstrate that the transaction had what we call a "business purpose."

The subjective business purpose inquiry "examines whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved."[11] To determine that intent, the following evidence has been considered by the courts:

(i) whether a profit was even possible;

(ii) whether the taxpayer had a nontax business reason to engage in the transaction;

(iii) whether the taxpayer, or its advisors, considered or investigated the transaction, including market risk;

(iv) whether the taxpayer really committed capital to the transaction;

(v) whether the entities involved in the transaction were entities separate and apart from the taxpayer and engaging in legitimate business before and after the transaction;

(vi) whether all the purported steps were engaged in at arms-length with the parties doing what the parties intended to do; and

[11] Shriver v. Commissioner, 899 F.2d 724, 726 (8th Cir. 1990) (citing Rice's Toyota World, supra note 7).

(vii) whether the transaction was marketed as a tax shelter in which the purported tax benefits significantly exceeded the taxpayer's actual investment.[12]

Objective Component

Now let's focus on the objective component of the doctrine. In order to satisfy the objective component, the taxpayer must demonstrate that the transaction resulted in a meaningful and appreciable enhancement in the net economic position of the taxpayer (other than to reduce its tax)[13]. Courts have used different measures to determine whether a transaction satisfies this objective economic substance requirement. One measure is whether there is a legitimate potential or realistic possibility for a pre-tax profit.[14] Of course, even competent investors lose money on some of their investments. Thus, a transaction is not required to actually result in a profit in order for the taxpayer's transaction to have objective economic substance.[15] Generally speaking, however, a potential for profit is present when a transaction is carefully conceived and planned in accordance with standards applicable to a particular industry, so that judged by those standards the hypothetical reasonable businessman would participate in the investment.[16]

Now another way courts have been willing to recognize the objective economic substance of a transaction is if, in lieu of a reasonable possibility of profit, the taxpayer

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[12] Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966); Sacks, supra note 5; Winn-Dixie, Inc. v. Commissioner, 113 T.C. 254 (1999) aff'd, Winn-Dixie Stores, Inc. v. Commissioner, 254 F.3d 1313 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002); Rose, supra note 8; Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir 1990); Newman v. Commissioner, 894 F.2d 560, 563 (2d Cir. 1990); Salina P'ship v. Commissioner, T.C. Memo 2000-352 (2000); Kirchman, supra note 10; Nicole Rose Corp. v. Commissioner, 117 TC 328 (2001); IES Industries Inc. v. Commissioner, 253 F.3d 350, 355-356 (8th Cir. 2001); James v. Commissioner, 899 F.2d 905 (10th Cir. 1990); Pasternak, supra note 7.

[13] Some courts have indicated that an appreciable effect on the taxpayer's legal relations or non-tax business purpose satisfies objective economic substance. See ACM P'ship, supra note 7, at 248 n.31.

[14] See, e.g., Gilman v. Commissioner, 933 F.2d 143, 146 (2d Cir. 1991).

[15] See Abramson v. Commissioner, 86 T.C. 360 (1986).

[16] Cherin v. Commissioner, 89 T.C. 986, 994 (1987).

establishes that the transaction resulted in some other meaningful and appreciable enhancement in the net economic position of the taxpayer.[17] These courts take the position that the IRS cannot disregard transactions that result in such an actual meaningful and appreciable enhancement in the taxpayer's net economic position (other than the mere reduction in its tax).

It is not enough for a transaction to have merely occurred. The transaction must have appreciably changed the taxpayer's net economic position before it will be given effect for tax purposes.[18] Thus, in the context of property dispositions, courts have applied the economic substance doctrine to disregard transactions which, although involving actual dispositions of property at a loss, had no net economic effect on the taxpayer's economic position, either because the taxpayer retained the opportunity to reacquire the property at the same price, or otherwise offset the economic risk of the disposition.[19] Likewise, the mere formation of a corporation[20] or partnership[21], or the making of an actual payment[22], in view of all of the relevant facts and circumstances in a particular case, does not necessarily in and of itself result in a meaningful and appreciable enhancement in the taxpayer's net economic position.

Raising the Economic Substance Doctrine

In the past twelve months, the courts have been given the opportunity to apply the economic substance doctrine in several high profile cases. In some of the cases,

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[17] See Knetsch v. United States, supra note 7.
[18] See Gilman, supra note 14; Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn. 2004).
[19] ACM P'ship, supra note 7, at 249.
[20] Gregory v. Helvering, 293 U.S. 465 (1935).
[21] ACM Partnership, supra note 7.
[22] Knetsch, supra note 7.

such as Long Term Capital Holdings[23], the Government prevailed. In others, such as the Castle Harbour case[24], which by the way was decided in the same federal district court, the taxpayers prevailed. So when should the IRS assert the economic substance doctrine?

Generally, there are three common situations when the IRS needs to determine whether the economic substance doctrine should be asserted in a particular case. First, revenue agents need to determine whether the doctrine applies to a transaction which is under examination. Second, IRS attorneys need to determine whether the argument should be pursued in Tax Court proceedings. Third, for cases in federal district courts or the U.S. Court of Federal Claims, IRS attorneys need to determine whether to include the doctrine in the defense letters that we provide to the Department of Justice.

In all three situations, it seems to me that we should take a serious look at asserting the economic substance argument in those cases where the tax result produced by the transaction does not appear to be in accord with Congressional intent and common sense. In such cases, I believe that it is appropriate for our revenue agents and attorneys to drill down further to determine if the transaction should be respected.

Now in each of these three situations, it is very important for us exercise discretion in determining whether to utilize an economic substance argument in any particular case. The doctrine of economic substance is not to be used as a general antiabuse rule raised in every case where the taxpayer receives tax benefits that the IRS views as unintended or just because we do not like the transactions. Let me repeat

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[23] Supra note 18.
[24] TIFD III-E Inc., supra note 5. See also Black & Decker Corp. v. United States, 2004 U.S. Dist. LEXIS 22835 (D. Md. 2004) and Coltec Industries Inc. v. United States, 62 Fed.Cl. 716 (2004).

that by saying it another way: the economic substance doctrine should be used only rarely and judiciously. However, let me also be clear that consideration should be given to using the doctrine in cases where, even though there are sufficient technical arguments to be made -- which, of course, should be asserted as our primary arguments -- the facts also show that the transaction generated the tax benefits at issue, with no meaningful and appreciable enhancement in the net economic position of the taxpayer (other than to reduce its tax).

If, the economic substance doctrine applies to a particular transaction, then the IRS should go ahead and assert the doctrine, regardless of whether there are technical arguments that also may apply. However, in those cases where there are technical arguments available to the IRS, while it may still be appropriate to raise the economic substance doctrine argument, it should only be asserted as a secondary or tertiary argument, following any appropriate technical arguments. This means that, there will be some cases in which the IRS asserts the economic substance doctrine in addition to asserting technical arguments, but there will also be other cases in which the IRS asserts the doctrine even if technical arguments are not available.

Necessary Factual Development

Now remember that there are two components to the doctrine: the subjective component and the objective component.

In a case involving a perceived tax shelter, where our agents and lawyers are developing the subjective component -- the business purpose component -- one way to do this is to uncover evidence to demonstrate that the taxpayer primarily planned the transaction for tax purposes. Such evidence may include:

(i) documents or other evidence that the transactions at issue were sold as tax shelters with limited consideration of the underlying economics of the transaction;

(ii) evidence that the taxpayer, or its advisors, did not investigate the market risk prior to entering into the transaction;

(iii) evidence that the independent parts making up the transaction were not entered into at arm's length, and

(iv) evidence that a prudent investor would have or could have accomplished similar objectives using much simpler or more direct methods.

A direct source of such evidence regarding the taxpayer's contention of a nontax business purpose is written correspondence or other communication between the taxpayer and the promoter of a particular transaction, including, but of course not limited to, offering memoranda, letters identifying tax goals, and electronic messages. In-house communications at the offices of the taxpayer, the promoter, and any accommodating parties may also be useful. Indirect sources of evidence include correlations between tax benefits generated and tax benefits requested, and between the taxpayer's economic income and the tax benefits generated, particularly if it can be shown that the income to be sheltered was attributable to an unusual windfall, like the liquidation of stock options, or the sale of a business. Demonstrations of similarities of the nature and extent of tax benefits acquired by other clients of the promoter of the particular transaction under examination can be very important as well.

In developing the objective component of the doctrine -- economic substance -- in cases where profit should reasonably be an economic consequence of the transaction, we want our agents and attorneys to develop facts to show that the

transaction could not have been actually profitable or at best was only possibly nominally profitable. These facts must either support a conclusion that the taxpayer could not profit from the transaction or, at best, that the taxpayer could realize only a nominal profit.

In most cases, the taxpayer will probably argue that even if the transaction at issue was not expected to create an opportunity for profit, the transaction nevertheless has objective economic substance because the economic relationships of the parties to the transaction were meaningfully altered. We must approach this issue with an open mind since our role is not to impede or discourage bona fide business transactions.

However, I want to make it crystal clear that the IRS is not bound to respect transactions lacking in objective economic substance. We see cases where there is no real change in the net economic position of the taxpayer. In order to determine whether a particular transaction has objective economic effect, the IRS must consider all of the relevant facts and circumstances, including any side agreements or oral understandings among the parties, the relationships of the parties, and the effects of local law. For example, it is common, as part of a tax motivated transaction, for taxpayers to create or terminate a substantial contractual obligation. But any change in the nature of the obligation will not be meaningful if the change is prohibited or offset by a separate written or oral agreement among the parties or the operation of state law.

Before I conclude, I would like to make two final points. Throughout this speech I have talked about how our agents and lawyers should approach the issue of economic substance in their cases. It is important to keep in mind that tax practitioners should approach the issue in the very same way. By that I mean that they too should consider

whether one or more of the judicial doctrines, including economic substance, would apply to a transaction they are reviewing to determine whether the tax benefits the promoter of the transaction claims are available to the client really are available. They too should ask themselves whether a transaction which meets the literal language of the Code or regulations is consistent with the intent of Congress at the time the provision or provisions were added to the Code. And so on.

One other point. Take a look at the Coordinated Issue Paper that was recently done for Notional Principal Contracts. It uses a methodology like the one I described here to you today to go through the issues in a clear and precise manner so that the judicial doctrine of economic substance is to be raised in that particular type of tax shelter only after full consideration is given to the technical arguments in the case.

Conclusion

Unfortunately, over the past 10 years we have witnessed a resurgence of tax shelter activity that has caused great damage to the integrity of our tax system. We have many cases under examination and many others in various stages of litigation. In working these cases, we must keep in mind that the economic substance doctrine is not a general antiabuse rule that can be raised to attack every transaction that the IRS does not like. On the other hand, taxpayers and practitioners should not forget that the doctrine is an indispensable tool which the IRS must be able to employ, to challenge transactions where the tax results appear inconsistent with Congressional intent and common sense. What this means is that in appropriate cases, the IRS will use all of the tools at its disposal to combat abusive tax shelters, including the economic substance doctrine.

That ends my prepared remarks. I would be pleased to answer any questions you may have.